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USDOC FOR 4320/ITA/MAC/WH/ONAFITA/ARUDMAN
USDOC FOR ITS/TD/ENERGY DIVISION
TREASURY FOR IA (ALICE FAIBISHENKO)
DOE FOR INTERNATIONAL AFFAIRS KDEUTSCH AND SLADISLAW
STATE PASS TO USTR (EISSENSTAT/MELLE)
STATE PASS TO FEDERAL RESERVE (CARLOS ARTETA)
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SUBJECT: ECONOMIC TRANSITION NOTES, NOVEMBER 9-15, 2006

Summary

11. (U) Fitch Ratings warned that Mexico's credit rating could fall in the next three years if President-elect Calderon fails to pass reforms needed to encourage faster economic growth. Calderon continued to publicly call for reforms, and promised to encourage financing for infrastructure; strengthen financial institutions and capital markets; increase security; and invest in human capital. Bank of Mexico (BOM) Governor Guillermo Ortiz again called for more competition in the financial and telecommunications sectors, and for economic reforms. Reported discussions on the 2007 budget, however, indicate it will not include structural reforms. Calderon and his transition team continue to publicly lay out their priorities including construction of 1 million houses a year, plus highways, railways, ports, and airports; and allowing PEMEX to enter into joint ventures for deep-water oil exploration and production. Some economic reforms are progressing. The Finance Secretariat expects to authorize five new banks, including one by Wal-Mart de Mexico, within two weeks. The Secretariat has also drafted a bill to make it easier for the government to recover assets when banks go into bankruptcy. Mexico's Federal Competition Commission blocked the merger of railroads Ferrosur and Ferromex. Controversy over the Cell Phone QCalling Party Pays system continues, but authorities maintain that the new system will be implemented. Consumer price inflation in Mexico rose to a 15-month high in October, but the BOM still maintains that inflation will drop below 4% by yearend. Industrial production rose by a still-strong 5.0% year-over-year in September. End Summary.

Credit Rating Could Hinge on Economic Reform

12. (U) Shelly Shetty, Fitch Ratings' Senior Director of Sovereign Ratings, said publicly that Mexico's credit rating could fall in the next three years if President-elect Felipe Calderon fails to pass the fiscal, energy,

labor, and educational reforms needed to encourage faster economic growth. "Politics will define the trajectory of ratings in Mexico," Shetty said at a conference in Mexico City. She said that Calderon must find a way to break the gridlock in Congress that prevented President Vicente Fox from passing much-needed economic reforms. She noted that these reforms are particularly important because oil prices and U.S. demand will slacken next year.

Central Bank Stresses Need To Strengthen Economy and Diversify Trade

13. (U) Deputy Central Bank (Bank of Mexico, BOM) Governor Guillermo Guemez said publicly that Mexico should strengthen its domestic market and diversify its trade to face an expected economic slowdown in the U.S. Guemez said that the government should improve Mexico's productivity so that it relies more on its domestic market than abroad. Guemez added that reforms are needed to improve the country's competitiveness.

Ortiz and Calderon Discuss Economic Growth, Competition and Competitiveness

14. (U) BOM Governor Guillermo Ortiz spoke at the Mexican Foreign Trade Council's (COMCE) annual conference on November 6. As in previous speeches, Ortiz called for more competition in the financial and telecommunications sectors, and asserted that competitiveness is tightly linked with fair competition. He criticized the large gap in the total annual cost for credit cards in Mexico and abroad. He noted that while Citibank's annual cost in the U.S. is 22.4%, its subsidiary Banamex charges 62.2%; HSBC's annual cost in the U.K. is 21.7%, whereas in Mexico it is

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74.1%. Noting that Mexico's low economic growth rate shows a lack of competitiveness and low productivity, he stressed that Mexico is losing ground to Asian and Eastern European countries. Ortiz recommended approving reforms to make the labor market more flexible, encourage innovation and technology, and open key sectors of the economy to more competition. He also called for more government investment in education, health care, and infrastructure.

15. (U) At the same conference, President-elect Calderon called for energy, fiscal, labor, and pension reforms and for the creation of export-oriented productive chains to regain market share and achieve sustained economic growth. Calderon promised to encourage financing for infrastructure to reduce logistical costs, and to strengthen financial institutions and capital markets to increase access to credit at competitive interest rates. He also promised to increase security and invest in human capital through better educational and training programs.

Infrastructure Will be a Calderon Priority

16. (U) Dionisio Perez Jacome, Deputy Coordinator of Economic Policy on Calderon's transition team, said publicly that the incoming administration will make construction of highways, railways, ports, and airports a priority. Regarding tourism, Perez said that the government will develop other tourism sites, so-called QIntegral Planned Centers, Q such as Nayarit, Palenque, Chiapas, and Chihuahua, and that it will consolidate a tourism project in the Mar de Cortes. In the housing sector, he said the incoming government's goal is to construct 1 million houses a year.

Planned Energy Reform To Include Joint Ventures for Deep Water

17. Perez also said the Calderon government will allow PEMEX to enter into joint ventures for deep-water oil exploration and production. He said the incoming

government will look for investment for refineries, natural gas, and petrochemicals; a new fiscal regime for PEMEX; a stronger Energy Regulatory Commission; and long-term contracts for major energy consumers and private producers.

2007 Budget Will Not Include Structural Reforms

¶8. (U) Gustavo Madero, Chairman of the Senate Finance Committee, said publicly that the 2007 budget will not include structural reforms. Agustin Carstens, the head of Calderon's economic transition team, met with senators on November 13 to discuss the 2007 budget package. Madero said that they discussed how oil production and revenues would probably be lower next year and the need for more resources to pay public pension liabilities and long-term infrastructure contracts (so-called Pidiregas debt). Madero said Calderon's transition team will present a cautious budget this year in order to facilitate discussion on fiscal reform in the coming year. Institutional Revolutionary Party Senator Jose Eduardo Calzada acknowledged Carstens's willingness and openness to negotiate with all political parties.

Outgoing Fox Administration Drafts Bankruptcy Law, Plans Other Reforms

¶9. (U) The Finance Secretariat (Hacienda) sent the Federal Commission for Regulatory Improvement (Cofemer) a draft bill that would make it easier for the government to recover assets when banks go into bankruptcy. Guillermo Zamarripa, head of Hacienda's Banking and Savings Unit, said Hacienda will leave the draft bill ready for the incoming administration to submit to Congress. Zamarripa also said that before the end of the Fox administration on

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November 30, 2006, the Finance Secretariat will present reforms to create specialized banks, regulate outsourcing, and strengthen the National Banking and Securities Commission (CNBV).

Wal-Mart To Get Banking License

¶10. (U) Mexico's Finance Secretariat on November 15 said that it has given the green light for the opening of five new banks, including one by Wal-Mart de Mexico, and that it expects to give final authorization within two weeks. The other banks that the Secretariat said it expects to approve applications for are Banco Facil, Banco Comercial Del Noreste, Bancoppel, and Prudential Bank -- bringing to 13 the number of new banking licenses financial authorities have granted this year. The entry of these banks into the financial services market will generate more competition in the sector and expand banking services to low-income Mexicans, a segment of the population that traditionally has not been served by Mexico's large retail banks.

Anti-trust Commission Rejects Rail Merger

¶11. (U) Mexico's Federal Competition Commission on November 10 blocked the planned merger of Ferrosur and Ferromex. This was the second time that the commission rejected the merger of these two companies, which would have created Mexico's largest railroad firm. The commission first rejected the plan in June, ruling that the merger would hurt competition. The owner of Ferrosur said it may challenge the ruling in court.

Controversy Continues Over QCalling Party Pays (CPP)

¶12. (U) The head of the Federal Telecommunications Commission (Cofetel) said last week that Cofetel will not allow companies that refused to implement CPP to affect the majority. His statement came after the fixed line telephone companies (including Mexican companies Alestra, Avantel, and Axtel) that had obtained an injunction against

implementing CPP complained that calls from their customers to cell phones were being blocked. Mobile companies countered that they were only alerting their customers with a phone message informing them of the charges they were about to incur before connecting calls from non-participating fixed line companies. In response to the complaints, Cofetel decided that mobile phone companies were not violating the Federal Telecommunications Law because they were not blocking calls. One of the commissioners stated that despite the injunctions against CPP, the system will be implemented. The commissioner explained that mobile phone companies are only warning their customers that they will have to absorb the cost of the long distance calls coming from fixed line phone companies that have not implemented CPP, which Cofetel does not consider to be blocking calls.

Inflation Climbs to 15-Month High

¶13. (U) Consumer price inflation in Mexico rose to a 15-month high in October as the price of tomatoes, electricity, milk, and onions surged. Prices climbed 0.44% in the month, bringing the annual inflation rate to 4.29% - above the Bank of Mexico's (BOM) target of 3% and outside the 2% - 4% band it considers acceptable. The BOM still expects inflation to fall below 4% by yearend.

Industrial Production Figures Still Strong

¶14. (U) Industrial output rose by 5.0% year-over-year in September, down from 5.6% the month before but still slightly above market estimates. On a monthly basis, output rose by a seasonally adjusted 1.0%. Growth is largely being led by a booming construction sector. Most market analysts expect growth rates to continue to soften in the final quarter of the year and into 2007, in part due

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to the economic slowdown in the U.S.

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